THE INDUSTRIAL POLICY DEBATE

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PREFACE

Much has been said and written on whether the United States should adopt a policy of assisting industrial development. This study, prepared at the request of the Office of the Senate Minority Leader, provides a framework for understanding the industrial policy debate, the economic changes that precipitated it, and the alternative policy options that have been proposed. In keeping with the mandate of the Congressional Budget Office (CBO) to provide objective analysis, the report makes no recommendations.

This paper was written by Elliot Schwartz of CBO's Natural Resources and Commerce Division, under the supervision of David L. Bodde and Everett M. Ehrlich. Michael Mandler contributed substantially to the analysis contained in Chapter II. Other research assistance was provided by Paul McCarthy, Julia McKenzie, Mark Adams, and Jim Simmons. The report benefited from many valuable comments on earlier drafts, particularly from Philip Webre, Louis Schorsch, Bob Dennis, Linwood Lloyd, Jeff Nitta, Steve Sheingold, Bob Hartman, George Iden, Steve Quick, Sally Ericsson, Ken Leventhal, Arnold Packer, Gerard Adams, and Howard Wachtel. Francis Pierce edited the manuscript, Philip Willis typed numerous drafts, and Kathryn Quattrone prepared it for publication.

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SUMMARY

The term "industrial policy" represents not so much a policy as a debate over the best way to address America's long-term industrial problems. Everyone agrees that the country's basic manufacturing industries face both short-term and long-term difficulties. At issue is the role of government in addressing these difficulties and whether special programs that would complement fiscal and monetary policies would be appropriate. Supporters of a new, activist industrial policy would like the government to take a more interventionist role in solving industrial problems and rationalizing government policy toward industry. They hold that the present economic recovery, even at best, will not eliminate structural problems in the form of high unemployment, underutilized industrial capacity, and depressed communities. Supporters of a traditional free-market policy argue, on the other hand, that the government already intervenes too much and that intervention may represent part of the problem. They hold that industrial policy is inappropriate because economic growth can be maintained through conventional fiscal and monetary policy tools and flexible prices and wages. This paper examines the competing claims of alternative industrial policy proposals, evaluating their risks and benefits. It does not, however, try to choose among them.

Industrial policy proposals aim at three major goals: improving the economy's overall performance; meeting foreign competition; and assisting workers, firms, or communities to adjust to economic change. The pursuit of **overall goals** envisions improving total economic performance by overcoming problems in specific sectors and industries that affect employment, output, or prices. Some proponents go even further, arguing that government should take an active role in altering the structure of the economy. They would pursue **competitive goals** by promoting specific industries in competition with other nations. Finally, some have **adjustment goals**--that is, they would seek to ease the problems of workers, firms, or communities seriously affected by market-driven change. Such programs may be compared to the special policies developed to assist the agricultural sector in earlier years as the economy shifted to manufacturing.

The pursuit of these goals raises questions about the appropriate role of government in the economy. Public policy in the United States has traditionally been conceived as relying on private markets, although there has been a great deal of direct intervention. Industrial policy proponents suggest that the government should now intervene even more actively and

coherently in the affairs of particular industries and firms. They argue first that a formally even-handed approach is not really even-handed because some industries or firms benefit more from it than others, and second that considerable uncoordinated intervention already takes place. They recommend that the government should recognize the differential impacts of its present policies and go even further in the direction of targeting benefits to industry. In the extreme, this policy has come to be known as "picking winners and losers," although most proposals only seek to follow and build on market signals.

Many industrial policy proposals would seek to achieve a national consensus on economic goals by bringing government, labor, management, and other groups together to work out agreements on policy. Experience indicates that consensus building is a highly significant, although intangible, element of economic vitality.

THE CHANGING STRUCTURE OF U.S. INDUSTRY

Industrial policy proposals draw their impetus from the problems associated with adjusting to the long-term trends in the U.S. economy, which may not be amenable to resolution through fiscal and monetary policy or perfectly functioning private markets. These include: the expansion of the service sector relative to goods production; a slowing in productivity growth and in rates of capital investment; high levels of unemployment; greater cyclical instability, particularly in industries that are sensitive to interest rates and international trade; and an increasing openness of the U.S. economy to international trade and capital flows. But not all recent economic trends are bad. The economy has shown considerable strength in terms of overall growth in employment (despite high unemployment rates), a high absolute level of productivity compared to the rest of the world, and a leveling off in the decline of the U.S. share of world trade that occurred in the 1950s and 1960s. The bad news, however, remains sobering--particularly the declining rates of productivity growth and capital formation.

These trends seem to be related to major structural changes that have been taking place in the U.S. economy: the maturation of basic industries; increased international competition in domestic as well as foreign markets; a rapid expansion of the labor force; and the lingering effects of the oil crisis. These long-term trends are the focus of industrial policy concerns. Short-term difficulties caused by large budget deficits and tight monetary conditions are reserved for monetary and fiscal policy. For example, much of the present international trade difficulties can be attributed to overvaluation of the dollar, which in turn reflects unusually high real interest rates resulting, in part, from the high federal deficits projected for coming years. Other trade difficulties may arise from adjusting to the long-term erosion in productivity and rising unit labor costs.

As industries mature, they tend to grow more slowly. This has been so for a number of U.S. manufacturing industries. In a healthy economy, new expanding industries can compensate for the long-term decline of older industries and lead to a new cycle of growth. Data on compositional change in the economy, however, indicate that the rate at which new industries are replacing older ones seems to have slowed during the 1970s, accounting in part for the economy's relatively poor performance.

Increased international competition is one factor accelerating the maturation of older industries and inhibiting the development of new ones. Competition comes not only from the highly developed European and Japanese economies but from newly industrializing nations. The diffusion of new technology abroad has become very rapid. The United States has thus lost much of its former predominance in world trade. Some U.S. industries have lost export markets and even part of their domestic markets to foreign competition, creating major problems of adjustment.

The expansion of the labor force in the 1970s also brought a number of economic problems. Although employment grew rapidly, the number of those seeking employment grew even faster. This also contributed to the difficulty of conducting economic policy, since efforts to increase employment ran counter to measures aimed at reducing inflation. In this perspective, the huge employment growth of the 1970s must be considered a major accomplishment.

The oil crises of the 1970s had direct, harmful effects on the U.S. economy, raising the rate of inflation and cutting real incomes. They also helped foreign competitors capture large portions of certain U.S. domestic and international markets, particularly in automobile production as Americans shifted to smaller cars that had been developed abroad. The resulting uncertainties, particularly reflected in high real interest rates, have led businesses to focus increasingly on short-term goals, making them hesitant to undertake new expansion.

These structural changes have contributed to the economic problems underlying much of the industrial policy debate, including: the broad-based slowdown in productivity growth; the increased instability of the economy during the 1970s; and the migration of population and employment from the old industrial areas of the Northeast and Midwest to the South and West.

CURRENT FEDERAL POLICIES TOWARD INDUSTRY

An industrial policy implies the formulation of goals for specific sectors or industries and coordinated efforts to achieve them. The United States does not have a unified industrial policy, although it has a potpourri of policies that affect industrial growth--often unintentionally. These include monetary and fiscal policies, credit subsidies, and specific features of tax laws, as well as policies in the areas of procurement, trade, research and development, economic adjustment, regional development, and competition. 1/

Procurement. Federal procurement of major equipment, most of it for defense, is estimated at $58.2 billion in fiscal year 1983. These purchases take major shares of output in some industries, such as aircraft and shipbuilding, and affect many others as well. Other important outlays go to public works infrastructure, costing $24 billion a year.

Trade. Trade programs seek either to promote exports or to inhibit imports. Credit subsidies through the Export-Import Bank, and tax benefits from Domestic International Sales Corporations, provide most of the impetus to increase exports. Protection against import competition is provided by a variety of tariffs, quotas, and regulations.

Research and Development. The Congress has supported research through a variety of tax subsidies and funding programs and through building facilities and testing prototypes, particularly in defense and energy projects. Support for R&D is usually justified on the ground that private firms tend to underinvest in these activities. Federal support has played a major role in the development of the agriculture, aerospace, communications, nuclear energy, and computer industries.

Economic Adjustment. Some federal programs seek to ease the process of adjusting to change. The Reconstruction Finance Corporation, established during the Depression, was one such program. The Job Training Partnership Act of 1982 established new programs to assist displaced workers, while Trade Adjustment Assistance provides some adjustment benefit to workers displaced by import competition.

Regional Economic Assistance. Various federal programs encourage economic development in particular regions or among targeted populations. These programs are uncoordinated and highly politicized.

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1. Many specific tax and credit programs are detailed in a forthcoming Congressional Budget Office publication on federal support of business.

Competition. The Congress has taken action to regulate competition in several distinct areas through antitrust laws and laws aimed at destructive competitive practices. It has also intervened to ensure that business practices reflect the public interest as they affect the environment and health and safety. These policies define the rules of competition and represent the most basic form of industrial policy.

ALTERNATIVE INDUSTRIAL POLICY STRATEGIES

A myriad of proposals have been made to establish a consistent industrial policy. Among them three broad categories of alternatives can be discerned:

- Leave the current policy framework intact. Rely instead on the standard instruments of fiscal and monetary policy to facilitate stable growth.
- Reform current policies that relate to industrial growth.
- Establish a new industrial policy institution. Three distinct, although not mutually exclusive, options for this are:

  --an information/consensus-building agency;
  --an executive-branch coordinating agency; and
  --a financial institution.

Staying with Current Policy Instruments

The current policy view of industrial problems is one of managing aggregate levels of investment, employment, and economic growth. It allows private markets to determine the composition of economic activity, and to resolve industry-specific problems. Essentially it relies on monetary and fiscal levers to guide the economy. There are also a large number of programs, such as those mentioned above, that assist or retard specific forms of industrial development, whether purposefully or not. These measures constitute an implicit industrial policy in that they affect incentives to work, save, and invest.

Proponents of current policy argue that further government intervention is unlikely to be successful, and that current problems are not so different from those of the past that they cannot be addressed within the current policy framework. To the extent that there are new problems, they can be handled by existing agencies such as the Departments of Commerce

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and Labor and the Council of Economic Advisers. According to this point of view, many of the industrial problems now faced by the United States are short-term in nature, a result of the recent recession, and will abate as economic growth takes hold. Longer-term problems are best addressed by private markets and existing institutions. This would avoid new government intervention, the creation of new government agencies, and the further intrusion of politics into economic decision making.

Against a reliance on current policies, it may be said that no matter how vigorous and sustained the current economic recovery proves to be, many long-term structural problems may remain. Productivity growth, for example, seems unlikely to return to historic levels. Unemployment rates are projected to remain high for the foreseeable future. The economy may undergo further structural changes that exceed the ability of free markets to adjust to them.

Moreover, many of today's problems are new, particularly the level and scope of international competition. It may be argued that new policy tools are necessary to avoid the kind of economic dislocation--such as the shift from agriculture to manufacturing--associated with previous structural changes in the economy.

Reforming Current Policy

Those who would reform current policy feel it is necessary to make American industry more competitive internationally by freeing it from certain domestic restraints. This option views industrial problems as caused by marginal imperfections in current laws and institutional practices.

For example, some believe that U.S. firms are at a disadvantage when competing with foreign firms that are able to merge or to form cartels. Moreover, some activities, in particular research and development, might be more efficiently carried out on a cooperative basis. This view calls for changes in the antitrust laws.

Efforts to reduce the burden of social regulation--such as consumer protection, environment, and job safety rules--are based on the belief that these regulations force industry to bear excessive compliance costs and hinder competitiveness. Other deregulatory proposals, such as repeal of the Glass-Steagall banking regulations, are aimed at changing the rules of competition in order to channel more funds into long-term investment.

Proposals to stimulate trade include greater funding for traditional export promotion programs as well as action to lower and stabilize the foreign exchange rate of the dollar. Proposals to protect domestic industry from import competition include greater use of countervailing duties and passage of domestic content legislation for automobiles.

Programs have also been proposed to assist workers who are unemployed because of economic change. These programs include readjustment services to help dislocated workers find new jobs, wage subsidies to encourage employers to hire them, and additional income support to ease the difficulty of adjustment.

A strategy based on policy reform would have several potential advantages. Some would accrue from updating current policies to take account of economic changes that have made them out of date--for example, reforming antitrust laws and banking regulations that were developed under different economic conditions. At the very least, such reforms might lead to better competitive practices. Other advantages would include: effecting change with minimal budgetary costs (as through deregulation); improving U.S. competitiveness in specific product areas through export promotion; and avoiding further intrusion of the federal government into the marketplace.

Critics of this strategy call it an inadequate, piecemeal response to a complex set of problems. It would affect industrial policy concerns only indirectly, often more as a result of addressing other legitimate concerns such as deregulation. Moreover, some of the specific reforms might involve a cost to the general public by reducing competition and weakening consumer protection.

Establishing a New Institution

An Independent Information/Consensus-Building Agency. The least obtrusive of the proposed new agencies would be set up outside the executive branch to gather and disseminate information on the problems of industry, to develop consensus among opinion leaders, and to guide action. It would have no program to enforce. Some have proposed using such an agency as a means of working out an incomes policy through consensus agreements on wages and prices. One version would give it the power to spend public funds to help industries modernize along agreed-upon lines. In general, this approach presupposes that part of the problem of industrial competitiveness is a lack of market information.

The information/consensus agency is the least risky of the proposed new institutions, because it would have no administrative power. It would not interfere with private decision making or efficient resource allocation.

Rather, firms or groups might revise their intended actions as they saw fit on the basis of new information or after participating in consensus agreements.

To be successful, the agency would need to persuade a variety of competing interest groups to subscribe to a common understanding of the economy and to agree to the necessary policy measures. But its likelihood of success would be small, particularly if it had no financial assistance to offer and no ability to compel attention or action. The administrative costs of the agency might then exceed its social benefits. Comparable agencies in other industrialized nations have failed to accomplish much. Even where successful, as in Japan, the agency may have reduced adaptability to change because of the need for agreement before action.

A Coordinating Agency. This institution would coordinate and rationalize executive-branch programs, marshalling the resources of the federal government to address industrial problems. It would view the industrial problem as due, in part, to inadequate, conflicting, and poorly focused federal industrial programs. The Administration's proposed Department of International Trade and Industry (DITI) is one variation of such an agency.

Greater coordination of policy could lead to more effective assistance to industry. It could avoid inconsistencies between programs--for example, between free trade and economic adjustment policies. In addition, such an agency would provide a forum for discussion of problems and issues, and could inform the President about instances in which executive-branch programs and policies were working at cross-purposes.

On the other hand, a centralized agency for industrial policy might tend toward bureaucratic intervention into certain industries at the expense of the economy as a whole. Or it might add to the cumbersome nature of decisionmaking without improving the quality of decisions. Examples of the bureaucratic failure of centralized foreign industrial policy agencies abound, such as France's efforts in computers and aerospace.

A Financial Institution. This proposal calls for the creation of a national industrial development bank, which could target assistance to specific industries and offer financial aid to induce industrial change. Specific proposals vary in the powers and duties they would give the bank. Some would have it provide limited funds to industries in need of them, either to assist new industries or to revive declining ones. Others would give the bank greater funding as well as other powers, such as guaranteeing prices for new products.